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DIRECTORATE OF
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Intelligence Memorandum

Current Status Of The Israeli Economy

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
October 1971

INTELLIGENCE MEMORANDUM

CURRENT STATUS OF THE ISRAELI ECONOMY

Introduction

1. Israel entered 1971 with unemployment and idle plant capacity at rock bottom levels and with output expanding at an annual rate of about 7%. The consumer price level had risen 10% over the course of 1970, however, and the balance of payments had become a source of chronic anxiety. Despite large-scale private assistance and a drawing of US $265 million on an arms-related US credit, reserves of gold and foreign exchange were a modest $450 million, well below the $690 million level of three years earlier. This memorandum assesses the economic situation as Israel moves into the final months of 1971.

Discussion

Domestic Economy

2. As 1971 progresses, the Israeli economy is expanding briskly and straining at the limits of capacity. Unemployment has been reduced to a record low, and an estimated 40,000 residents of the occupied territories now work in Israel, providing a 4% supplement to the domestic civilian labor force. Real gross national product (GNP) is growing at an annual rate of about 7%, approximately the rate that revised data indicate was achieved in 1970.

3. Israel, however, has serious problems stemming from overheating of the economy. The budget originally proposed by the government for the current fiscal year (1 April 1971 - 31 March 1972) probably was inflationary, given the full employment status of the economy; and

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

subsequently adopted fiscal measures have increased inflationary pressures. Spending boosts resulting from unforeseen hikes in labor costs, defense construction, and construction of public housing were only partly offset by an increase in fuel levies effected in July. Between December 1970 and May of this year, the money supply increased 11% and consumer prices 4.4%. The 22 August devaluation of the Israeli pound from $0.286 to $0.238 – which was intended to improve the balance of payments – immediately intensified the pressure on domestic prices, as Israel is heavily dependent on international trade. The government responded with subsidies on bread, milk, eggs, and edible oils, an extensive and cumbersome system of administrative price controls, direct subsidies to low income families, and strict limits on the expansion of bank credit. These controls are to remain in effect through 1972. Tax increases were ruled out (except for a tax on firms that raise prices on sales from inventories accumulated before the devaluation). The rise in consumer prices over the course of the entire year is expected to exceed last year's increase of 10%, despite the new controls.

4. Labor unrest, a difficult problem in the final portion of 1970, again reached serious proportions this summer. Most of this year's difficulties seem to involve government employees – for example, workers and physicians in government hospitals, employees of the national electric corporation, workers at the Elat water desalination plants, postal employees, and customs agents. Administrative and service employees in hospitals operated by the health fund of the Histadrut (the omnipresent labor federation), stevedore foremen, busdrivers, and engineers also have been embroiled in disputes. The majority of this year's strikes have been conducted without the approval of the Histadrut, and some have been in violation of valid labor contracts. The wave of price increases following the devaluation has evoked demands for a compensating increase in labor's tax free cost-of-living pay supplement, but the government so far has resisted this push.

Balance of Payments

5. Israel's balance-of-payments position remains precarious but certainly is better than a year ago. An increase in the deficit on merchandise trade has been offset by gains elsewhere in the accounts.

6. The deficit in merchandise trade was 14% greater in the first half of this year than in the comparable portion of 1970 despite a larger proportional increase in exports – 24% – than in imports – 19%. (Statistics on merchandise trade do not include arms imports, which are carried in the services accounts.) The trade picture for the first six months of 1971 was as follows:

	Million US $
Imports	879
Exports	468
Trade deficit	411

Widening of the trade gap can be attributed to a substantial increase in imports of civilian ships and aircraft. Excluding transfers of ships and aircraft from the balance, the trade deficit declined 8% from $325 million in the first half of 1970 to $298 million in the first half of this year. Israel is in the process of expanding both its fleet of tankers and freighters and its inventory of commercial aircraft, a process that is expensive in the near term but promises to enhance the country's long-run balance of payments. With purchases of civilian ships and aircraft taken into consideration, it is apparent that the favorable movement in the trade balance that was engineered in the second half of 1970 via a series of taxes and subsidies has not been sustained. The trade deficit for the first half of 1971 – although smaller relative to the volume of trade – exceeded in absolute amount the deficit that was considered intolerable just a year earlier.

7. An outstanding feature of trade performance in 1971 has been recovery in sales of two principal exports – diamonds and citrus fruit. Earnings from exports of fresh citrus had declined in 1970 because of a drop in European citrus prices; however, earnings from the 1970/71 crop were about 30% above receipts from the preceding crop.* Citrus earnings for calendar year 1971 will be about $112 million versus $83 million in 1970. Exports of all agricultural products probably will be up 25% from last year's level to something more than $160 million. Diamond exports had fallen in 1970 because of weak demand in foreign markets, especially in the recession-troubled United States. Thus far in 1971, however, diamond exports have been well ahead of 1970 levels, and for the entire year an increase of 15% to about $235 million is in sight. Exports of non-agricultural products other than diamonds ran nearly 20% above last year's pace during the first six months of this year. Such exports should maintain a similar edge for the remainder of 1971 and may approximate the $475 million predicted in May by the Israeli government. Any stimulus to this year's exports from the devaluation will be concentrated on non-agricultural products other than diamonds.

* *Israel's citrus export season runs from November to May.*

8. Israel's tourist industry is earning foreign exchange at an unprecedented pace. Some 37% more tourists visited Israel in the first six months of 1971 than in the comparable portion of 1970, and the number of visitors from the United States was up 40%. For the entire year, receipts from tourism excluding travel fares will approach $130 million, exceeding last year's receipts by one-fourth. The principal constraint on tourist earnings is hotel space, and hotel construction is booming.

9. Defense-related imports, including "indirect" defense imports by defense industries, will approximate the $825 million level of last year, barring significant changes in the security situation. Defense imports are constrained by the United States' willingness to sell – and to finance the sale of – major military items to Israel. The United States has included in its fiscal year 1972 budget a $300 million credit to Israel for arms purchases. In the preceding fiscal year a similar credit was extended in the amount of $500 million.

10. Receipts from private gifts and purchases of concessionary development bonds also are running ahead of last year's. However, an expected decline in total long- and medium-term borrowings (including receipts from development bonds) probably will more than offset the anticipated rise in unilateral transfers.

11. Prior to the recent devaluation, it appeared that Israel would have an uncovered balance-of-payments deficit of about $75 million in calendar year 1971, although an Israeli projection released in May had suggested that a gap of $215 million was developing. If an uncovered deficit should materialize, it would have to be met by an increase in foreign gifts and loans or by a drawing down of Israel's modest reserves of gold and foreign exchange. For several months, the US Government has had under consideration an Israeli request for a $200 million grant over and above the $300 million loan already included in the US budget.

Devaluation

12. The balance of payments will, of course, be influenced during the remainder of the year by the 22 August devaluation. The pound long had been seriously overvalued, and the 10% tax that was imposed on most imports into the United States on 15 August aggravated the pound's difficulties.* The US import levy and other international monetary

* *The US import surcharge affects an estimated 16% of Israel's exports. However, its impact is mitigated by anomalies in US regulations. For example, the levies on large and small diamonds have been increased by only 4 and 3 percentage points to 10% and 8%, respectively.*

developments caused a flurry of speculation against the Israeli pound during the week of 15 August. Moreover, popular confusion concerning the monetary situation provided a convenient cloak for devaluation, lessening domestic opposition to the move.

13. Pinchas Sapir, Israel's Minister of Finance, has estimated that the devaluation will benefit Israel's balance of payments by $150 million to $200 million during the coming year and a half. This would be a modest result. The deficit on exchanges of goods and services was $1.2 billion last year, and prior to the devaluation it was projected at $1.3 billion for this year. A portion of the benefit would merely offset the adverse effect of the US import surcharge. On the other side of the ledger, however, the balance of payments is benefiting from such external monetary developments as appreciation of the German mark, the French franc, the Japanese yen, and other currencies relative to the dollar and thus to the Israeli pound, which is pegged to the dollar.

14. Several factors suggest that the impact of the devaluation on the balance of payments will be both mild and transitory. First, the extent of the devaluation is moderate. The cost of dollars in terms of pounds has been increased 20%, from I£ 3.50 to I£ 4.20, and the cost of pounds in terms of dollars has been reduced 17%, from $0.286 to $0.238. In contrast, the 1962 devaluation boosted the pound cost of dollars by 67% and chopped the dollar cost of pounds by 40%. Second, although the surcharge that was imposed on most imports last year (20% is the general rate) has been retained, export subsidies apparently are being reduced. Export subsidies formerly ranged from I£ 0.72 per dollar on products comprising less than 25% value added in Israel to I£ 1.12 per dollar for products comprising more than 66% value added in Israel. The government has indicated its intention to adjust the subsidy to a range of I£ 0.85 to I£ 0.89 per dollar. The third factor detracting from the success of the devaluation is more basic and more complex than the others. It is the likelihood that no appreciable decline in Israel's absorption, or use, of goods and services will be tolerated by the public or enforced by the government.

15. To reduce imports relative to exports and make the devaluation effective, it is necessary that the country's absorption of goods and services be restrained. Imports have been outstripping exports by far, with the difference being paid for by gifts and loans from abroad – often solicited on an emergency basis – and in certain periods by the drawing down of reserves accumulated during more favorable times. Thus Israel has been using far more goods and services than it has produced. Any attempt to reduce absorption by cutting government consumption will be resisted by the government and by most of the body politic. Spending on education and welfare measures was boosted sharply in the budget for the current fiscal

year, and there has been heavy pressure in recent months for still greater outlays. The pressure on defense spending also is upward. The general public and especially the powerful Histadrut oppose any widespread drop in real personal income. The government has no desire to cut investment, for that is needed to increase economic output and enhance Israel's defensive strength. In sum, there is no place where big economic cutbacks can be made without considerable reluctance and resistance.

16. Some kind of contractionary economic measures must be enforced if absorption of goods and services is to be restrained and the balance of payments significantly improved. But no meaningful increase in tax levies or other sufficiently contractionary measures have been proposed by the government. On the contrary, Sapir has reiterated an earlier pledge to hold the line on taxes through this fiscal year. Limits that have been placed on the expansion of bank credit will provide some restraint, but they are inadequate. Controls that ostensibly are to hold the post-devaluation rise in consumer prices below 5% in 1971 and provide continued restraint through 1972 will result in excess demand if they are effective. Would-be buyers will exceed would-be sellers at legal prices, and some goods will have to be distributed by non-price rationing, probably on an informal basis.

17. Prices were rising at an annual rate of roughly 10% even before the devaluation, and the devaluation has raised the cost of foreign purchases 20%. One-sixth of the consumer goods sold in Israel are imported either in semi-finished or final form, and the average import content of goods manufactured in Israel probably is about 50%. The 20% rise in foreign exchange costs does not, however, delineate the full extent of the inflationary effect of the devaluation. Changes in currency parities have increased the quantity of Israeli products that will be demanded. Foreigners now will seek more Israeli wares because their cost in foreign currency has dropped. This is, in fact, the rationale for devaluation. But Israelis also will demand more domestic products because the pound cost of competing foreign goods and services has risen. Appreciation of the mark and certain other currencies by a greater amount than the dollar relative to the Israeli pound exacerbates Israel's inflationary problem.

Conclusions

18. The Israeli economy is operating at full capacity under conditions of excess aggregate demand. In the coming months, output will continue to grow at an annual rate of about 7%. Unemployment and idle plant capacity will remain at very low levels, and employment of workers from the occupied territories may be increased. Upward pressure on prices will continue, fed by government fiscal laxity and aftereffects of the 22 August devaluation. The consumer price index is expected to rise more than 10% over the course of 1971.

19. Recently imposed controls will keep prices from rising still faster but will cause economic distortions and no doubt will be evaded in some instances. The August devaluation of the Israeli pound will afford only minor and temporary relief to balance-of-payments difficulties, and Israel's foreign exchange position will remain precarious. Strong deflationary measures would relieve upward pressure on prices and improve the balance of payments, but their enactment is highly unlikely. In the absence of an upsurge in defense imports, however, the $300 million special loan to Israel that is included in the current US budget should be sufficient to prevent a serious drawdown of Israeli reserves in the coming months.